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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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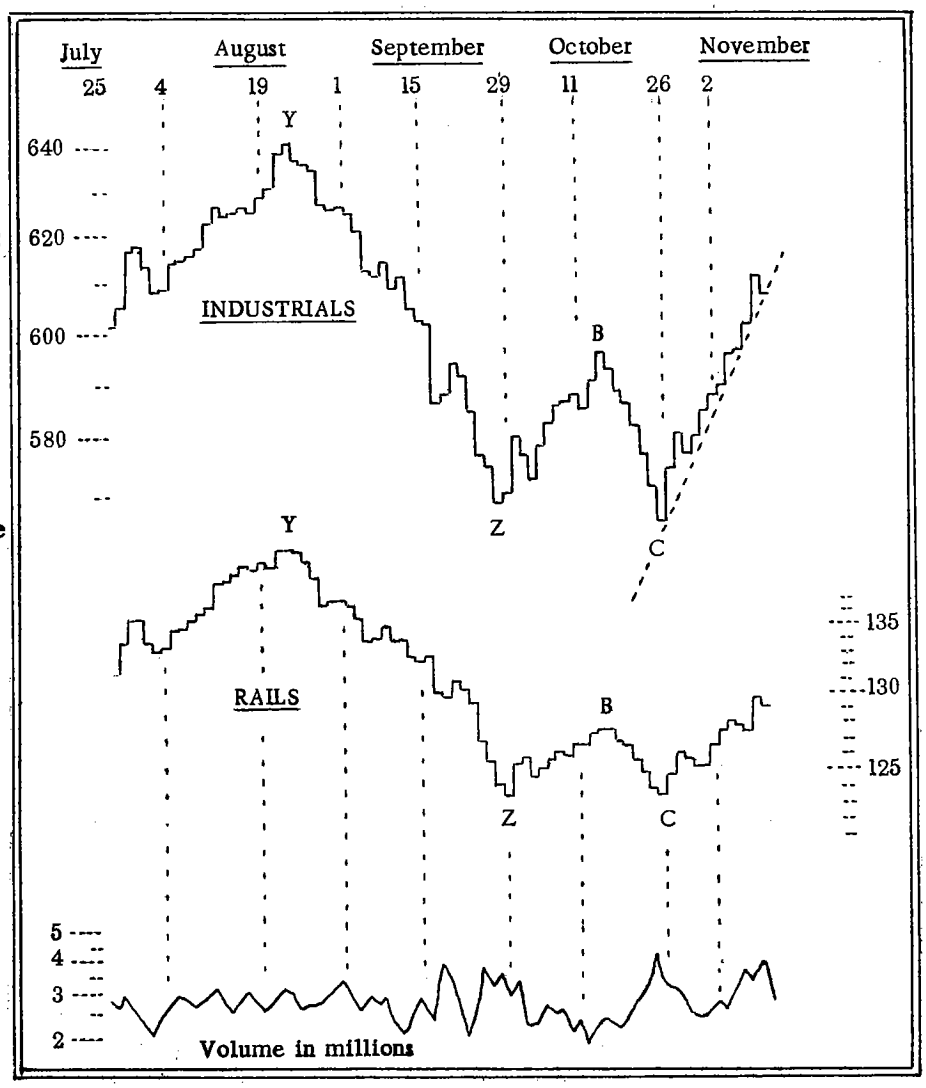
THE MARKET If a trendline is drawn through the recent Industrial closings (see chart) it is apparent that we have witnessed one of the steepest climbs in the 64 year history of the Averages. During the advance from point C Industrials rose on ten out of eleven sessions. This fact taken together with the almost perpendicular rate of ascent suggests a violence which is usually associated with heavy short-covering and a "sold-out" market.

The final election returns show a popular vote so incredibly close that we cannot know (at this time) whether the market was anticipating a Kennedy or a Nixon victory. The market's initial response to the Kennedy win was the November 9 intra-day drop of over seven points. This early selling probably stemmed from conservative sources who were fearful of a Democratic victory. Later in the day a sharp rally advanced Industrials to a closing gain of over four points. It is the opinion of this observer that (following the penetration of the B points) the market was already engaged in a full secondary correction of the T-Z downswing and that nothing in the final election results came as a surprise or a disturbance to the market. The instances where the market is actually taken by surprise are few and far between; when such instances do occur the market goes into a panic (i.e. Eisenhower heart attack -- 1955, fall of France -- 1940, San Francisco earthquake -- 1906).



Dow Theorists generally do best when they focus their attention on the price movements while ignoring the news of the day (which is usually discounted by the market well in advance). Thus from the standpoint of the price movements Letter 122 stated: "If the B points are jointly bettered (particularly on increasing volume) the secondary trend will be pointing up for the first time since June." On November 3 the Rails bettered B; on November 7 Industrials confirmed by bettering their own B point. The Industrial confirmation took place on the day before election, and it came on sharply increased volume (see chart). This means that (regardless of the election)

the recent formation has been part of a secondary (upward) reaction which was correcting the third primary leg of the bear market.

The third leg began for Industrials on June 9 (656.42) and ended on October 25 (566.05), which represents a loss of 90.37 points in 96 trading days. The same leg began for Rails on March 17 at 146.56 and ended on September 29 at 123.37, resulting in a loss of 23.19 points in 132 trading days.

Letter 119 included a number of quotes from Hamilton and Rhea concerning bear market rallies. One of the quotes ran as follows: "It has often been pointed out...that the rally in a bear market is apt to be sharp and relatively short. Stocks seem to recover faster than they went down, and not infrequently from 30 to 40 per cent of a decline extending over four months is recovered in as many days." (Hamilton, July 29, 1910).

During the first eleven trading days of the rally from C the Industrial Average recovered 46 points or 50% of a 90 point decline which extended over 96 trading days. While this comparison may seem startling, when judged against the bear market action of the past one can only say that it is "par for the course".

Normally, secondary reactions tend to correct (retrace) 1/3 to 2/3 of the losses sustained during the preceding primary leg. The current advance has already exceeded the minimum normal expectation. The maximum normal expectation (although it is never wise to dogmatize) would be a rally to 626.

TECHNICAL NOTES The 30 week moving Average (see Letter 119) now stands at 613.80.

Odd-lot transactions have moved steadily towards the buying side during the advance since C, and (despite heavy odd-lot shorting) this is a sign of increasing technical weakness. I have mentioned before that I do not attach as much significance to shorting in a bear market (shorting with the trend) as I do to shorting in a bull market (which is speculation against the primary trend).

I suggest that readers review the section on "TOPS" in Letter 120.

CONCLUSION The primary trend remains bearish. The secondary trend turned up on November 7 and will remain up as long as one or both Averages hold above the bear market lows (Industrials at C, 566.05, Rails at Z, 123.37).

POST-ELECTION COMMENTS Personally, I have never been able to wax poetic over either political party; moreover, I seem to have developed that rare faculty of almost always picking the losing candidate. A good deal of "hogwash" is bandied about during every campaign, but sometimes that hogwash is repeated so often that people begin to take it for the truth. For instance, a great bull market ended in 1929. Herbert Hoover was unlucky enough to be in office at the time. I do not care what anybody's opinion of Hoover is or was, but the facts are these: Hoover was fated to be President when the greatest bull market in history turned into history's worst bear market. In my opinion, the 1929-32 bear market would have occurred regardless of who was President. In 1929 Hoover had no inkling of how bad things were going to be (but neither did anybody else). To make matters worse, Hoover's cold personality and dogged optimism in the face of disaster did not endear him to the American people.

The primary trend turned bullish on July 8, 1932. On that date the market discounted the absolute worst that could be seen ahead. The economy had nowhere to go but up. That same month (amid some of the most frightening pessimism ever recorded) Robert Rhea called the turn of the tide as he announced (July 20): "It is time to shut your eyes and buy them to the limit."

In November, four months after the new bull market began, Roosevelt was elected. Democrats have always claimed that Roosevelt started the bull market, but any Dow Theorist worth his salt knows better. My own opinion of Roosevelt is not important, but Rhea

firmly believed that whatever improvement came during the 1930's occurred despite Roosevelt, not because of him. At any rate, if we credit the bull market of 1932-37 to the Democrats, logic demands that we also credit them with the crash of 1937-38. All of which makes as much sense as today's Republicans taking credit for a bull market that started in 1949 when Truman was President. If the 1949-59 bull market was a "Republican boom", then who does the bear market which began in 1959 belong to?

Kennedy and the Democrats have been complaining about high interest rates' stifling our "growth rate", but during the years 1934 to 1939 interest rates on short-term Treasury bills never got above 1%, and nobody was talking about a growth rate then. Currently, sales of appliances, houses, steel, paperboard, copper, etc. are sluggish, and I do not believe the problem has a thing to do with interest rates. There comes a time when people are over-extended, and no amount of "easy money" will make a man spend when he's "spent-up". Over the last six months installment debt costs have run 13.1% of total after-tax income. 13% is considered the critical or "shut-off" point.

It had been my opinion that regardless of the election outcome, the next President would have all the economic troubles he could handle. Our gold outflow is now accelerating and is, in fact, reaching shocking proportions. During the worst week of 1960 the country lost 180 million dollars worth of gold. Now we learn that during the week ending November 9, 218 million dollars of gold was lost. If this type of foreign withdrawal continues it can only have the most disastrous repercussions. It will be interesting to see whether the Democrats can turn the tide, for if they do they will be making history. The current outflow of gold (to say nothing of the recession) is the result of many years of inefficient factory operation, excess production, corporate "fat", inflated wages, union "featherbedding", overpricing and poorly-made products. These practices grew under both parties; they would have had to end under either party.

QUESTION "In Letter 122 you discussed the mechanical plotting by the Averages of a bull or bear signal. You also discussed the phases, volume indications, psychology, etc., all of which are an aid in confirming the validity of the mechanical signals. Have false (mechanical) bull or bear signals ever been given by the Averages?"

ANSWER Yes, on a few occasions. For this reason Rhea once warned: "Students generally pay entirely too much attention to the matter of penetration of a previous high or low point, while disregarding other evidence...." In 1926 a particularly complicated secondary reaction caused Hamilton to call a bear market. The bull market had not yet seen its third phase, but Hamilton had turned bearish on the economy, and for once in his life he allowed his preconceived notions to interfere with his cold appraisal of the market. Hamilton reversed his position a few months later after recognizing his mistake.

Another extremely deceptive "signal" came 4 years later (Hamilton died in 1929). In 1930, following the "crash", a great secondary (upward) reaction occurred. As Rhea described it, when the seondary highs were bettered by both Averages "... many observers took it to be a bull market signal." He continued, "I can remember having shorted stocks in early December, 1929, after having completed a satisfactory short position in October. When the slow but steady advance of January and February continued, I became panicky and covered at considerable loss. With losses piling up every day, I forgot that the rally might normally be expected to retrace possibly 66% or more of the 1929 downswing. Nearly everybody was proclaiming a new bull market. Services were extremely bullish, and upside volume was running higher than at the peak in 1929."

In 1953 and again in 1957, despite the fact that the market had not evidenced third phase characteristics, many would-be Dow Theorists cried "bear market". Actually the Averages plotted what seemed to be mechanical bear signals. In early Letters I commented on the fact that prior to 1958 the average yield on the D-J Industrials had stayed well above 4.25%, low-priced stock action had been relatively stagnant, volume had been unimpressive and the public had remained relatively uninterested in the stock market. All of these factors pointed to the probability of a coming third phase of the bull market, following which the validity of a bear signal could be accepted (see Barron's, December 1, 1958 -- "Dow Theory Revisited").

QUESTION "What would happen if too many people followed a single market system such as individual stock charts or Dow's Theory?"

ANSWER If too many people were to follow a given market method, then in all likelihood that method would (at least

temporarily) be discounted by the market and rendered useless. Often a single method will work well for an extended period of time -- until it gains a wide following. At about that point the method usually (and mysteriously) stops working.

In 1920's Colonel Ayres's "Flast Furnace Index" received wide acclaim. The theory was that when blast furnace operations advanced above 60% of capacity stocks were too high and should be sold; when furnace capacity dropped below 60% stocks were too low and should be bought. This system worked remarkably well throughout the relatively normal period of the '20's. In 1930 blast furnace operations sagged under 60%. Unfortunately, those who bought stocks on the 1930 blast furnace indications found that they had made purchases about three years too soon. The bear period of 1929-32 ended forever the popularity of the Colonel's Index.

Individual stock charting has become extremely popular, and perhaps it reached its peak of popularity during late 1959. This led to my warning (Letter 110) to the effect that (1) those who expect least from charts usually benefit most, and (2) charts are less reliable during the final stages of a bull market and the early stages of a bear market. Trading on the basis of charts proved singularly difficult through the latter part of 1959 and early 1960, but I have noticed that over the last few months stocks seem to "behave" more accurately in relation to their charted movements. This may be because the public has lost some of its enthusiasm for the market (and therefore for charts). Along these lines, thanks to Mr. Darvas and his "stop-loss" system (which can only work with a limited number of stocks during the third phase of a bull market), the public has become a bit more skeptical about the chances of "beating the market" via a mechanical system.

The possibility of the Dow Theory's gathering too wide a following seems a slim one. Along these lines, it is interesting to note that this has probably been one of the best documented declines in stock market history. I wrote a warning article for Barron's as early as September, 1959 ("Tiring Bull"), and that was followed by two other articles prior to the bear signal ("Tell-Tale Ratio", December, 1959; "Critical Point", February, 1960). Certainly the implications of Dow's Theory were available to thousands of investors throughout the country, yet the market was singularly unaffected at the time. A leading Wall Street analyst recently estimated that 33 billion dollars have been erased from stock values in the first nine months of 1960. Looking back over the period of the bear signal I can remember the utter skepticism and disbelief that surrounded the final announcement of a bear market. Certainly the evidence suggests that few people acted on Dow's Theory at a time when it was giving its most critical warning.

QUESTION "If bear markets tend to take less time than their preceding bull markets, how is it that the Averages don't zig-zag up ad infinitum? Doesn't this mean that the next bull market will go higher than the last one?"

ANSWER It is true that bear markets tend to last about one-third to perhaps one-half as long as the preceding bull market. However, a tabulation of thousands of days of bull and bear market action shows the following: In bull markets the average appreciation on advancing days was .70 points, average depreciation on declining days was .69. In bear markets average appreciation on advancing days was 1.18, average depreciation on declining days was 1.03. Thus bear market advances and declines tend to be faster (and more violent) than comparable action in bull markets. In other words, bear markets end faster than bull markets because they take less time to "get where they're going."

NOTES My friend Joe Granville (of E.F. Hutton) has written a book entitled "A Strategy of Daily Stock Market Timing for Maximum Profit" (Prentice Hall). The book is a most excellent and valuable contribution to technical market analysis. Subjects such as the Advance-Decline Ratio, the Confidence Index, stock charts, moving averages, etc. are discussed in detail, many new and interesting ideas appear for the first time in Joe's book. I recommend the work highly, and it is now available in bookstores.

I can supply chart paper suitable for plotting the daily closings and volume (8 1/2" X 11", bond paper, packed flat) at ten sheets for one dollar, postpaid. I have continually recommended the charting of the Averages to all serious market students (and I don't care whose chart paper you use).

(Written Monday, November 14th - 2 P.M.)

Thirty Stocks Used in Dow Jones Industrial Averages are:

Allied Chemical	General Electric	Sears Roebuck
Aluminum Co.	General Foods	Std Oil of Calif.
Amer. Can	General Motors	Std Oil N.J.
Am Tel & Tel	Goodyear	Swift & Co.
Am Tobacco	Inter Harvester	Texaco Inc.
Anaconda Co.	Inter Nickel	Union Carbide
Bethlehem Steel	Inter Paper	United Aircraft
Chrysler	Johns-Manville	Westinghouse El
DuPont	Owens-Ill Glass	U.S. Steel
Eastman Kodak	Procter & Gamble	Woolworth

Twenty Railroad Stocks Used Are:

Atchison	Erie-Lackawanna	NY, NH & H
Atl Coast Line	Illinois Central	Norfolk & West'n
Baltimore & Ohio	Great North Ry	Pennsylvania
Canadian Pacific	Kansas City Sou	Southern Pacific
Ches & Ohio	Louisv & Nash	Southern Railway
Chi Rk Is & Pac	N.Y. Central	Union Pacific
Del & Hudson	N.Y.C. & St. L.	